No. 78-956

In the Supreme Court of the United States

OCTOBER TERM, 1978

BERNARD JAY COVEN, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 4a-26a) is reported at 581 F.2d 1020. The initial opinion of the district court (Pet. App. 29a-56a) is reported at [1975-1976] CCH Fed. Sec. L. Rep. ¶ 95,222. The opinion of the district court on motion for reconsideration (Pet. App. 57a-69a) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on June 2, 1978. A petition for rehearing was denied on August 7, 1978 (Pet. App. 27a-28a). On October 24, 1978, Mr. Justice Marshall extended the time for filing a petition for a writ of certiorari to and including December 4, 1978. On November 27, 1978, Mr. Justice Marshall further extended the time for filing to and including December 15, 1978, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether reckless conduct that aids and abets violations of Section 17(a) of the Securities Act of 1933 is a sufficient basis for liability in an injunctive proceeding brought by the Securities and Exchange Commission.

2. Whether the court of appeals properly affirmed the district court's injunction against petitioner on a ground other than that relied on by the district court.

STATEMENT

In July 1973 the Securities and Exchange Commission filed a complaint in the United States District Court for the Southern District of New York against 11 defendants, alleging violations of registration, anti-fraud and anti-manipulation provisions of the federal securities laws[1] in connection with the public

[1] Sections 5(b) and 17(a) of the Securities Act of 1933, 15 U.S.C. 77e(b) and 77q(a); Sections 10(b) and 15(c)(2) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) and 78o(c)(2), and Rules 10b-5, 10b-6, 10b-9, and 15c2-4 promulgated thereunder, 17 C.F.R. 240.10b-5, 240.10b-6, 240.10b-9, and 240.15c2-4.

offering and trading of common stock of Dennison Personnel, Inc. ("Dennison") (J.A. 12a-18a).[2] Petitioner, an attorney specializing in securities law, was in charge of the public offering, and the complaint alleged that he aided and abetted most of the violations of the other defendants (*ibid.*).

The district court found that numerous violations of the securities laws had been committed by the defendant underwriter, its president, and various salesmen (Pet. App. 44a-49a, 53a-55a). It also found that petitioner had aided and abetted three of the violations (Pet. App. 49a-52a).

The first violation that the district court found that petitioner aided and abetted arose from the closing of the 3,000,000 share "all or none" portion of the Dennison stock offering.[3] The district court concluded that this closing violated Section 10(b) of the Securities

[2] "J.A." refers to the Joint Appendix filed in the court of appeals.

[3] The Dennison registration statement filed with the Commission provided for the offer of 6,000,000 shares of stock. The first 3,000,000 shares were to be sold under an "all or none" formula. As described in an exhibit to the registration statement drafted by petitioner, the underwriter was required to rescind all subscriptions and repay the purchase price to investors if it was unable to sell 3,000,000 shares within a stipulated period. To implement this "all or none" formula, funds received from investors were to be held in escrow and could not be disbursed until the minimum number of shares had been sold. This escrow arrangement was described in the prospectus disseminated to public investors (Pet. App. 7a).

Exchange Act of 1934 as implemented by Rule 10b-9 (Pet. App. 45a-46a) because the underwriter disbursed the proceeds of the offering to the issuer without selling the minimum number of shares specified in the registration statement (Pet. App. 49a). Petitioner aided and abetted the violation by advising the issuer that the closing could take place (*id.* at 50a-51a) and by representing unconditionally in an opinion letter to the escrow agent that 3,075,000 Dennison shares had been sold. Petitioner "had no basis whatsoever to make this representation" and "totally failed to make any inquiries" to find out how many shares had in fact been sold (*ibid.*).[4]

The district court also found that the underwriter had violated Section 17(a) of the Securities Act, and Section 10(b) of the Securities Exchange Act as implemented by Rule 10b-5, by failing to use its "best efforts" to sell the entire Dennison issue, contrary to representations in the registration statement (Pet. App. 33a-34a, 44a-45a). The district court held that petitioner aided and abetted that violation by failing to make inquiry of the underwriter's counsel regarding the underwriter's sales efforts and by his "total disinterest in learning whether the underwriters were attempting to sell the maximum portion of the Dennison issue" (Pet. App. 51a).

Finally, the district court found that petitioner's "failure to exercise minimum due diligence" aided

[4] The escrow agent had requested a letter from petitioner assuring it that the requisite number of Dennison shares had been sold before releasing investor funds from the escrow account (Pet. App. 36a).

and abetted manipulative trading by the underwriter and another brokerage firm that bid for and purchased Dennison stock during the distribution period, in violation of Section 10(b) and Rule 10b-6 (Pet. App. 51a).

In view of the serious nature of the securities law violations that it found, and the expectation that the defendants were likely to engage in similar future violations (Pet. App. 55a-56a), the district court enjoined the underwriter, its president and petitioner from violating anti-fraud and anti-manipulation provisions of the securities laws, including Section 17(a) of the Securities Act of 1933 (J.A. 43a-51a).

The court of appeals reversed the district court's finding that petitioner had aided and abetted the second and third violations (Pet. App. 26a). But it affirmed the finding that petitioner had aided and abetted the first violation when he caused the release of the proceeds contrary to the escrow agreement and contrary to the representations contained in the Dennison registration statement and prospectus (Pet. App. 22a-23a). The court concluded that this release of funds "plainly 'operated as a fraud' upon the public" (Pet. App. 21a), and that petitioner's false statement in his letter to the escrow agent that 3,075,000 shares had been sold was made in "reckless disregard" of its truth or falsity (Pet. App. 23a).[5] Under these circumstances, the court concluded, petitioner could be enjoined as an aider and abettor of a violation of

[5] In finding petitioner to be an aider and abettor, the court pointed out that he could anticipate that his letter was "likely to be used in furtherance of illegal activities" (Pet. App. 23a).

Section 17(a) of the Securities Act of 1933 (Pet. App. 21a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Review by this Court is not warranted.

1. Petitioner argues (Pet. 3) that he was held liable for "simple negligence" and that a conflict exists among the circuits regarding the standard of culpability in actions under Section 17(a) of the Securities Act of 1933. Contrary to petitioner's assertion, however, the court of appeals did not find that petitioner was merely negligent; the court held that his conduct was "reckless" (Pet. App. 23a). Accordingly, this case does not present the question whether "simple negligence" would be sufficient to sustain the injunction granted here.[6]

In any event, even if petitioner's conduct had been found to be only negligent, the decision below would

[6] In *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 194 n.12 (1976), which held that *scienter* must be proved in a private damages action under Section 10(b) of the Securities Exchange Act, this Court left open the question "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." Courts of appeals subsequent to *Hochfelder* have sustained findings of liability under Section 10(b) based on recklessness. See *Nelson* v. *Serwold*, 576 F.2d 1332, 1337-1338 (9th Cir. 1978); *Rolf* v. *Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 46 (2d Cir. 1978), cert. denied, No. 78-560 (Dec. 14, 1978); *Wright* v. *Heizer Corp.*, 560 F.2d 236, 251 (7th Cir. 1977); *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1039-1040 (7th Cir. 1977). See also *Coleco Industries, Inc.* v. *Berman*, 567 F.2d 569, 574 (3d Cir. 1977).

not conflict with the holding of any other circuit. Each court of appeals that has addressed the question has determined that, in statutory proceedings for injunctive relief brought by the Commission under Section 17(a), the Commission is not required to prove *scienter*, and that negligent wrongdoing may serve as the basis for an injunction prohibiting future violations of Section 17(a). See *SEC* v. *American Realty Trust*, 587 F.2d 1001, 1005-1007 (4th Cir. 1978); *SEC* v. *World Radio Mission*, 544 F.2d 535, 541 (1st Cir. 1976); *SEC* v. *Pearson*, 426 F.2d 1339, 1343 (10th Cir. 1970); *SEC* v. *Van Horn*, 371 F.2d 181, 186 (7th Cir. 1966). Petitioner has not cited any court of appeals decision that holds that *scienter* is required in an injunctive proceeding brought by the Commission under Section 17(a).[7]

Nor does this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), require the Commission to prove *scienter* in injunctive proceedings under Section 17(a).[8] As the court of appeals rea-

[7] Petitioner's reliance on *Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790 (7th Cir. 1977), is unwarranted. Although the court in *Sanders* stated (*id.* at 796) that an action under Section 17(a) could not be based on negligent wrongdoing, the court was considering a private damages action. One of the primary considerations in *Sanders* was that judicial creation of a damages remedy for negligence would disrupt the carefully drawn limitations that Congress prescribed in the express private remedy provisions of the Act. *Id.* at 795-796. That concern is not applicable here, because the present action is a government enforcement proceeding.

[8] *Hochfelder* left open the question whether *scienter* is necessary in an injunctive proceeding brought by the Commission under Section 10(b). 425 U.S. at 194 n.12.

soned (Pet. App. 14a-20a), *Hochfelder* depended on the language and legislative history of Section 10(b). That statute prohibits "any manipulative or deceptive device or contrivance" in contravention of Commission rules in language which this Court in *Hochfelder* viewed as connoting intentional wrongdoing. Section 17(a), by contrast, prohibits the making of "untrue" statements, the "omission to state a material fact," and engaging in a course that "*operates or would operate* as a fraud or deceit" (emphasis added).[9] These provisions of Section 17(a) cast a broader net than does Section 10(b), and they therefore do not require proof of intentional misconduct.

Moreover, despite petitioner's assertion (Pet. 10), this case does not raise the question whether *scienter* is required to sustain an injunction under Rule 10b-9. The court of appeals held only that petitioner violated Section 17(a) of the Securities Act of 1933 (Pet. App. 6a, 21a). It did not consider the question whether petitioner's misconduct also violated Rule 10b-9. In any event, petitioner cites no decision, and we are aware of none, that supports his contention that *scienter* must be proven in an injunctive proceeding under Rule 10b-9.

2. Petitioner further argues that the court of appeals deprived him of due process of law by holding

[9] The court of appeals here stated that "the clear import of the critical phrase * * * 'operates as a fraud,' is to focus attention on the *effect* of potentially misleading conduct on the public, not on the culpability of the person responsible" (Pet. App. 17a; emphasis in original). See also *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 212.

that he violated Section 17(a) when the district court's opinion did not rely on that provision (Pet. 16-17).

But the first cause of action in the Commission's complaint expressly charged that petitioner violated, *inter alia*, Section 17(a) as a result of his involvement in the closing of the "all or none" portion of the offering (J.A. 12a-16a).[10] The district court found that petitioner, by participating in the closing, had violated the securities laws. Although the court's opinion discussed only Rule 10b-9 in that connection, the misconduct was also clearly encompassed by Section 17(a). See, *e.g.*, *A. J. White & Co.* v. *SEC*, 556 F.2d 619, 622 (1st Cir.), cert. denied, 434 U.S. 969 (1977); *SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1094-1095 (2d Cir. 1972).[11]

Under these circumstances, the court of appeals did not deny petitioner due process of law by holding that he had aided and abetted a violation of Section 17(a), even though the opinion of the district court referred only to Rule 10b-9. Even if the district court had overlooked Section 17(a) in this respect, it is well settled that an appellate court may affirm a judgment on any ground that the law and record permit, including a ground not considered by the lower court. See

[10] The fourth cause of action charged petitioner with violating Section 10(b) and Rule 10b-9 based on his involvement in the closing (J.A. 18a).

[11] The district court's injunction incorporated the prohibitory language of Section 17(a). See J.A. 44a-45a.

Massachusetts Mutual Life Insurance Co. v. *Ludwig*, 426 U.S. 479 (1976).

3. Finally, petitioner argues that the court of appeals erred in failing to remand the case to the district court for reconsideration of the appropriateness of injunctive relief after it affirmed only one of the district court's findings of liability.

But petitioner has made no showing that the court of appeals abused its discretion in denying his request for remand. The court specifically set aside the lower court's injunction to the extent that it was based on findings of liability that were vacated (Pet. App. 26a). There was thus no need for a remand and the expenditure of additional resources. Appellate courts are capable of determining the necessity for injunctive relief.[12] Because petitioner played a key role in the Dennison distribution and recklessly caused the release of investor funds contrary to the terms of the escrow agreement, registration statement and prospectus, injunctive relief was appropriate here.[13]

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[12] See *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 197, 201 (1963); *SEC* v. *American Realty Trust*, 587 F.2d 1001, 1007 (4th Cir. 1978); *SEC* v. *World Radio Mission*, 544 F.2d 535, 543 (1st Cir. 1976).

[13] An injunction is properly based on a single serious violation of the securities laws. See *SEC* v. *Blatt*, 583 F.2d 1325, 1334-1335 (5th Cir. 1978); *SEC* v. *Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 90 (S.D.N.Y. 1970), modified, 446 F.2d 1301 (2d Cir.), cert. denied, 404 U.S. 1005 (1971).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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